

## Discussion on the Issue of Shorting

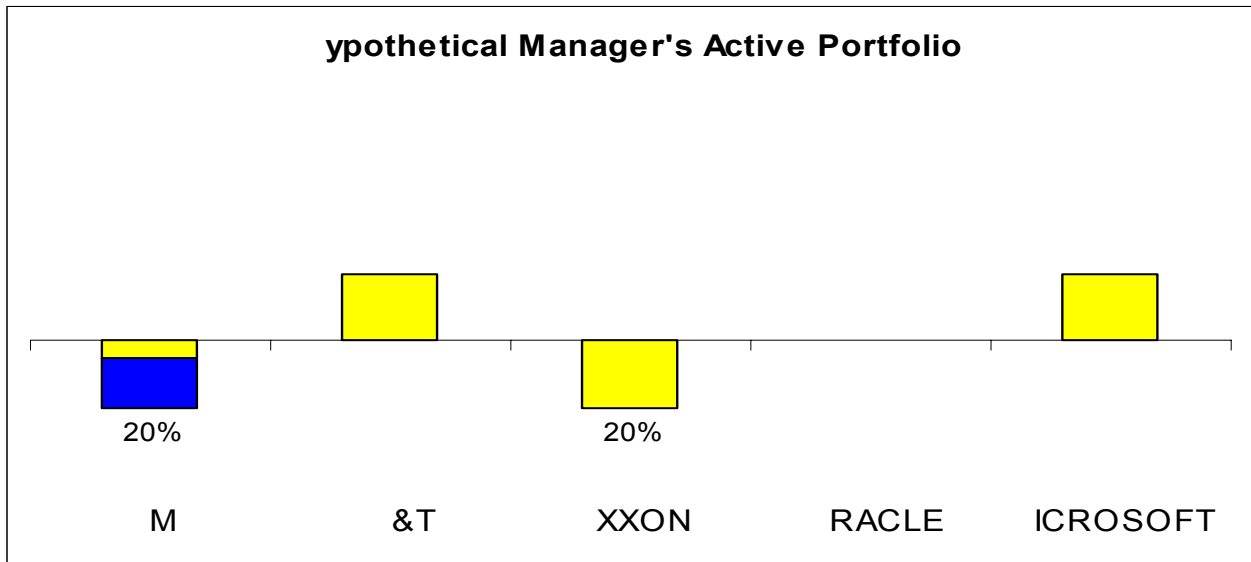
One objection that is frequently raised with strategies that employ a measure of shorting is that, in a long position, an investor can only lose 100% of the stock's value, while the loss from a short position is potentially unlimited and can be many times the stock's initial value.

Investors voicing this objection are looking at the portfolio's absolute holdings and returns and ignoring the benchmark-relative framework that applies to institutional investors. For institutional investors who have a broad equity benchmark as their policy allocation, the neutral holding of a stock is its benchmark weight, not zero. Given that the policy benchmark, and not cash, is the natural alternative to an active portfolio, the only meaningful risk of unlimited losses for an institutional investor applies to underweights relative to that benchmark, not to absolute positions. And it applies to all underweights, whether they're facilitated with short positions or not.

In other words, an institutional investor engaged in active investing is already exposed to short positions in the only way that is meaningful to the institution. There is no difference *in kind* between an underweight that results in a zero holding of a stock and one that results in a short position – both are underweights relative to the benchmark, which is the natural reference point. The only difference is in the *degree* of the underweighting.

Any institutional investor placing the concern for unlimited active losses above all other considerations must disavow not just short positions, but all active underweights, and so, by necessity, all active positions.

Perhaps the easiest way illustrate this point is through the underweights in the active portfolio of a hypothetical manager shown in the chart below. In this active portfolio, both 3M and Exxon are underweighted by the same amount, -20%. For Exxon, all -20% of its underweight comes from the benchmark. For 3M, only -5% of its underweight comes from the benchmark, with the other -15% coming from a short position. The fact that borrowed stock is used to establish one active position and not the other is irrelevant for their active risks and returns, which are exactly the same.



A smaller capitalization stock has less weight in the benchmark to be underweighted than does a larger stock. But that is no good reason for preventing a manager from underweighting a smaller stock to the same degree as a larger stock. Not allowing a manager to underweight smaller stocks to the same degree will only get in the way of effective implementation of information. The result likely will be less active return for the active risk or, conversely, more active risk for the same level of active return, which is to say, *not allowing short positions leads to a more risky portfolio.*